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After the 7th Inning Stretch
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It's that time of year again, pitchers and catchers report to spring training camps, and I start to think about America's pastime. As a lifetime baseball fan, I've observed there are generally three types of people who attend a baseball game (1) the fan who hoards beer before vendors shut off alcohol sales, aka: "the Beer Hoarder" (2) the fan who leaves after the 7th inning to beat traffic, "the Traffic Dodger" and (3) the fan who stays in his seat the whole game, every game, "the Lifer."

With the world awash in debt, and stock markets climbing virtually uninterrupted from the lows of 2009, we may be somewhere in the 8th or 9th inning of this bull market. Accordingly, sometime within the next 2 to 3 years, it's reasonable to expect a stock market downturn. If that downturn comes, we'll each have to decide which type of fan we are, the Beer Hoarder, the Traffic Dodger, or the Lifer.

The Beer Hoarder

In our opinion, speculators in cryptocurrencies as well as investors who hold nothing but Large, US Growth Stocks like the FAANGs (Facebook, Apple, Amazon, Netflix, Alphabet's Google) are Beer Hoarders. Some of them will have a good time after the game, but most of them will wake up the next day with a splitting headache and a few regrets.

Cryptocurrencies demonstrate textbook signs of a bubble. People I grew up with, who I know for a fact barely passed their high school math classes, are now blockchain experts. As someone who read and attempted to understand the seminal white paper penned by the mysterious creator of Bitcoin, Satoshi Nakamoto, something stinks.

Now, I've heard reasonable people make reasonable claims about the disruptive capabilities of blockchain technology, and many of them may ultimately turn out to be true, but we believe the vast majority of cryptocurrencies, which now number in the thousands, will ultimately have no value. Perhaps the best metaphor we've heard comes from prolific hedge fund manager, Ray Dalio, who compared blockchain technology to the internet, and cryptocurrencies to individual tech stocks in the late 90s/early 00s at the height of the Dotcom Bubble. [1]

That brings us to the FAANG stocks. We all know these companies: megabrands that many of us, directly and indirectly, interact with on a daily basis. The FAANGs are overvalued by traditional standards, such that in the event of a broad market downturn, their prices may decline sharply as investors flee to safety. Moreover, while this is certainly not an exhaustive analysis, there are a number of identifiable threats to each business. For example…

- I listened to a podcast recently, in which one industry analyst estimated the market value of Facebook and Alphabet's Google, taken together, to exceed the two companies' addressable market, online advertising. How can two companies be worth more than the total marketplace for their goods and services?

- Netflix may face increasing competition from other large, entrenched content providers and distributors, and Apple may continue to face competition from a variety of sources.

- That brings us to Amazon, with its seemingly infinite addressable market. What could possibly slow this juggernaut down? One word, Trump (credit to Jared Dillian of *The Daily Dirtnap*). The daily assaults on the President from Jeff Bezos' *Washington Post* may eventually bring down on Amazon a storm of antitrust and other legal pressure, with or without merit.

Maybe in our 20s or after a tough week at the office, we've all been the Beer Hoarder, but as mature adults, most of the time, we're either the Traffic Dodger or the Lifer.

The Traffic Dodger

The Traffic Dodger likes to play it safe. The first seven innings were fun, but the misery of sitting in gridlock traffic, trying to leave the parking lot, just isn't worth any potential excitement the 8th and 9th innings may offer.

Investors who maintained their stock portfolios through the abrupt stock market downturn from late 2007 to early 2009 were rewarded handsomely for their patience and discipline. The climb from 2009 to present has been unrelenting. Now, retirement is a lot closer than it was, and there's no defined benefit pension program waiting on the other side. Investors today are largely on their own to accumulate savings and appropriately distribute those savings over the course of a retirement that could span decades.

The primary risks these investors face include missing out on further gains and knowing when to get back into stocks. This is of course assuming stocks do a better job preserving and growing purchasing power than cash or bonds in the face of inflation, even for investors in or nearing retirement, because the investment horizon (life expectancy) could still be 10+ years. These investors are perhaps in the most difficult position, and must consider their next move carefully, weighing the potential outcomes and tradeoffs they are willing to accept.

The Lifer

Lifers will not leave the game under any circumstances. They know how hard it is to consistently predict the timing and magnitude of market movements. They've seen the data, which generally shows how smart, experienced, hardworking investment professionals often fail to consistently beat relevant market indexes over time. So, they control what they can, employing a strategic combination of low cost, tax efficient investment vehicles, each one tracking a different market index or type of investment. To borrow support for this approach from Peter Bernstein, "Diversification is the only rational deployment of our ignorance."

The risks Lifers face are largely emotional. Lifers won't necessarily be a hit at cocktail parties, and will never be fully immune from stock market downturns. Instead, Lifers must watch as their portfolios rise and fall, trusting the cyclical nature of human behavior will prevail. And it's been demonstrated, from boom to bust and back again, from the Great Depression to World War II, from the Dotcom Bubble to the Global Financial Crisis, and everything in between, staying the course generally serves the Lifer well.

One Last Pitch

The crowd is on its feet, there's a flame-throwing righthander on the mound, and the opposing team's best hitter steps up to the plate. Both sides have read all the scouting reports and crunched the numbers. Is it going to be the fastball, the slider, or the changeup?

For an educated guess of what comes next, we'll be watching interest rates on US Treasuries. Treasuries are the instrument the US Government issues to borrow money, and they are of systematic importance to global finance. Insurance companies and pension funds estimate their future liabilities, and then buy Treasuries to prefund them. Governments purchase them for a number of reasons, ranging from use in international trade, to political influence, to hedging against the risk that their own domestic currencies may decline against the US Dollar in which Treasuries are denominated.

Your intuition might tell you a longer-term Treasury with 10, 20, or 30 years to maturity should pay a higher rate of interest than a shorter-term Treasury with, say, 2 years to maturity. After all, a lot can change in 30 years, and a Treasury investor should be compensated for that risk with a higher interest rate. Citing recent history (2000, 2006 - 2007), when Treasury rates inverted, which is to say shorter-term rates came to be higher than longer-term rates, a significant stock market decline followed. Well, the gap between shorter-term rates and longer-term rates is narrowing, and if an inversion happens, each of us will have to decide: am I a Traffic Dodger or a Lifer?

[1] Please refer to FINRA's recently disclosure for investors titled "What You Should Know About Bitcoin" available at http://www.finra.org/investors/highlights/what-you-should-know-about-bitcoin

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Best,

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